INVESTMENT COMPANY INSTITUTE

MARY S. PODESTA
SENIOR COUNSEL

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Mr. P. K. Nagpal
Chief General Manager
Securities and Exchange Board of India
Mittal Court 'B' Wing, First Floor
224, Nariman Point, Mumbai-400 021

Dear Mr. Nagpal:

Following a meeting a few months ago in Washington, D.C. with staff of the Securities and Exchange Board of India (SEBI), the Institute was asked for its views on how the licensing system for foreign institutional investors (FIIs) in India could be improved. In particular, the SEBI staff asked whether "bottlenecks" exist that might be removed in order to streamline the process through which FII's invest in Indian securities. The Institute appreciates the opportunity to provide the views of its members on the FII regime.

We have surveyed Institute members that hold FII licenses and, based on their responses, set forth below a number of observations and recommendations on ways in which conditions for foreign investors in India could be improved. We understand that some of the areas of concern to our members may be outside of SEBI's areas of authority. Nevertheless, we included these concerns in order to provide as complete a picture as possible of the regulatory issues for foreign investors identified by our members.

Preliminarily, we would like to make two points. First, regulatory changes initiated by SEBI and implemented in the market have significantly improved India's clearance and settlement system and the environment for foreign investors in India. Indeed, many of the problems identified in the Institute's 1997 report entitled "Emerging Market Clearance and Settlement Issues for Investment Funds" have been successfully addressed.

Second, we would urge India to continue the process of making its securities markets more attractive to investment by abolishing the FII regime. We believe this would almost certainly result in greater foreign investment in the Indian securities markets, adding to the depth and breadth of trading in those markets and ultimately increasing the amount of capital available to Indian issuers. Moreover, this would bring India more in line with international investing norms. FII regimes only exist in a handful of countries around the world, and typically exist only if absolutely necessary to protect against harmful capital flows. India's FII regime was adopted in 1992 as a way to allow foreign investors to access Indian markets in the absence of a convertible currency and as a way to protect the rupee. As India has moved towards full convertibility of the rupee, that underlying rationale has disappeared. Thus, we would urge India to consider abolishing the FII system as soon as possible.

1401 H STREET, NW • WASHINGTON, DC 20005-2148 • 202/326-5826 • FAX 202/326-5841 • EMAIL: podesta@ici.org

SPECIFIC RECOMMENDATIONS

A. The Market Entrance Process for Foreign Investors

The administrative process of entering the Indian market for foreign investors has improved significantly over the past few years, but certain aspects of the licensing system remain somewhat onerous. A foreign investor that meets certain eligibility criteria must obtain approval as an FII from both SEBI and the Reserve Bank of India, and must renew its license every five years. There is a $5,000 application fee, both initially and upon renewal. The application form requires extensive supporting documentation.

1. Eligibility Criteria

In order to be eligible to obtain an FII license, a fund must be "broad-based" – that is, it must have at least twenty individual investors with no single investor holding more than 10% of the funds outstanding shares. This 10% limitation is difficult to comply with for new funds, since seed money investors tend to hold more than 10% of the fund, at least for some initial period. We recommend that SEBI consider an exception from the 10% rule for retail mutual funds that meet certain criteria, such as having investment objectives consistent with making investments in India.

2. Application, Documentation and Fees

We believe that the initial application process could be significantly streamlined. In particular, SEBI should consider reducing the amount of supporting documentation required, and reducing or eliminating the $5,000 fee. Moreover, FII licenses, once granted, should be of indefinite duration. We do not see any reason to require an existing FII license holder to renew its license after five years.

3. FII Subaccounts

One of the principal remaining "bottlenecks" reported by our members has to do with SEBI's system for adding subaccounts to an existing FII license. Subaccounts could be used for different series of series funds (common in the U.S.), subfunds of umbrella funds (common in Europe and elsewhere), or pension clients of the same institutional asset manager. The current rules require an FII's registration statement to be amended each time a new subaccount is added. This is time consuming, cumbersome and expensive.

We understand the need for SEBI to closely monitor the use of subaccounts, since each subaccount represents a separate investor.[1] However, we believe that because of the relationship between these subaccounts, the process for adding a subaccount should be considerably more efficient than licensing wholly unrelated investors.

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[1] For example, mutual funds that are series of a series fund organized under U.S. law are, for tax and securities purposes, completely separate and distinct investment companies. Similarly, different pension clients for an institutional asset manager are separate and distinct.

In our view, the process of adding subaccounts to an FII license is analogous to other contexts in securities regulation where an action is permitted with the proper regulatory filings but without the need for prior regulatory approval. For example, in the U.S., a mutual fund is permitted to add a series by filing a post-effective amendment to its registration statement with the SEC. The amended registration statement takes effect automatically 75 days after filing (or on a later date selected by the registrant), unless the SEC staff objects to something in the filing.

We would recommend that India take a similar approach to FII subaccounts, where subaccounts meeting certain criteria (to be determined by SEBI) could be added to an existing FII license after a certain period of time following a filing containing the necessary information.

4. Transfers of FII Licenses to Successor Entities

Several of our members noted that they have experienced significant delays following a technical change in the legal status of a fund, such as a change to the fund's name or the change in the fund's form of organization from a corporation to a business trust.[2] While we understand the need to control the transfer of FII licenses, in our view, name changes and other changes that do not involve a change of control should not be considered a transfer of a license and should not cause a fund holding an FII license to have to reapply for a new license. In these cases, the same entity effectively will hold the FII license both before and after the change. We therefore recommend that SEBI either allow FII licenses to extend to the license-holder's successor entities or create a streamlined way to re-issue FII licenses in these instances.

Our members also noted that it may be difficult to comply with SEBI's policy announced last month with respect to mergers of FIIs and/or subaccounts. The new policy requires FIIs to obtain SEBI's approval for all such mergers, and in doing so, to submit an application that contains, among other things, confirmation that appropriate regulatory approval has been received for the merger. Fund mergers in the U.S. do not typically receive regulatory approval. Instead, the fund boards must make certain findings, shareholders may be required to approve the transaction, and the funds must make certain regulatory filings. In recognition of this, we would recommend that SEBI allow FIIs to certify that the merger was completed in compliance with applicable rules and supplement that certification with appropriate documentation from the merger, such as a copy of the board resolutions, regulatory filings and proxy results (to the extent that shareholders were required to vote).

B. Investing Issues

1. Litigation Concerns

As we noted above, SEBI has taken a number of important steps to improve the clearance and settlement of securities in the Indian markets, including dematerialization. We applaud these positive developments. However, a number of our members reported concerns

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[2] Corporations and business trusts are the two most common forms of organization for U.S. mutual funds. These two forms of organization are functional equivalents under U.S. law and receive the exact same treatment under the Investment Company Act of 1940 and under U.S. tax law.

about possible litigation over shares that were purchased in physical form and subsequently dematerialized. As we understand it, there is no statute of limitations to claims of prior ownership on such shares, which means that all dematerialized shares carry a risk of litigation. We also understand that these claims can take years to resolve, and thus can be quite costly to deal with. As a result, the mere threat that such a claim could be brought remains one of the primary disincentives to investing in the Indian securities markets.

We strongly recommend that SEBI adopt a rule that bars claims of prior ownership to dematerialized shares[3] or, at a minimum, requires such claims to be brought against a centralized guarantee fund.[4] Physical shares should be required to be authenticated prior to being dematerialized. All claims of prior ownership must be resolved at that stage in order to provide an effective dematerialized environment. This concept, along with the result that the dematerialized shares trade free from claims of prior ownership, is critical to all dematerialized trading environments.[5]

2. Limits on Movements in Share Prices

It is our understanding that stocks in India currently are subject to limits on the movements in their share prices. The limits (sometimes called "trading collars") differ for different issuers – 2%, 5% and 10% depending on the issuer.

Trading collars present unique compliance challenges to U.S. mutual funds. The staff of the U.S. Securities and Exchange Commission's Division of Investment Management (the "SEC staff") has indicated its view that U.S. mutual funds might have to determine the "fair market value" of securities that reach their trading limits.[6] Obviously, multiple trading collars magnify these compliance challenges.

If SEBI believes that trading collars are necessary, we strongly recommend that it choose a single percentage limit of at least 10% that would apply to all Indian securities.

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[3] This is the approach taken in the U.S., where Article 8 of the Uniform Commercial Code provides rules that specifically regulate the rights, duties and obligations of the issuers of, and persons dealing with, uncertificated securities, including protections from liability for holders in due course.

[4] This approach has been taken in South Africa with its Dispossessed Members Fund (*see* www.strate.co.za for information) and Indonesia when it converted to scripless trading in 2000 (*see* Bapepam Rules III.B.6 and III.B.7).

[5] *See also* "Recommendations for Securities Settlement Systems," Report by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions (November 2001) (encouraging dematerialization to the "greatest extent possible" but urging a well founded, clear and transparent legal basis for all securities settlement systems).

[6] If the security reaches the trading collar price and no trading has taken place at that price, the SEC staff believes that funds must determine the fair value of that security. If trading has taken place at that price, funds must consider whether that trading represents a "readily available market quotation" under the Investment Company Act. If it does not, then the fund must fair value price the security. *See* Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated April 30, 2001.

3. Initial Public Offerings

The current rules require FIIs to use an escrow account in order to invest in initial public offerings. As we understand it, settlement on the purchase of IPO shares typically occurs one to two days after the funds are transferred out of the escrow account. This process appears to be an unnecessarily burdensome way to require FIIs to invest in IPOs, and one that exposes FIIs to additional settlement risk. We recommend that SEBI adopt a system under which settlement for IPO shares could be accomplished on a DVP (delivery versus payment) basis. We further recommend that SEBI consider removing the requirement that FIIs use an escrow account to facilitate these investments.

4. Disclosure of Significant Portfolio Holdings

Two separate SEBI regulations require disclosure of significant holdings. The SEBI takeover regulations require filing upon crossing percentage ownership thresholds of 10%, 14%, and 15% and at each 2% change after 15%. The SEBI prohibitions on insider trading require filing at a 5% threshold, and at each 2% change thereafter. As a result, FIIs are required to file various reports at thresholds of 5%, 7%, 9%, 10%, 11%, 13%, 14%, 15%, and every 2% thereafter.

The Institute and its members support the policies underlying the requirements to disclose significant ownership of issuers. Obligations to report ownership provide both issuers and the market with information about the accumulation of interest by investors in a particular issuer. These rules, however, should be drafted to balance the need for the market to learn promptly of the accumulation of securities by those who may seek to influence control over an issuer with the burdens that frequent reporting can place on institutional investors, such as mutual funds, pension funds and their managers, that have no such change of control purpose. In order to properly strike this balance, we strongly recommend that SEBI consider adopting a single, uniform system for reporting significant portfolio holdings. Alternatively, the SEBI takeover regulations could exempt mutual funds, pension funds and other institutional investors that are not investing for control.

In addition, our members have reported that it is unclear whether subaccount holdings should be aggregated at the FII level in order to determine percentage ownership for purposes of significant ownership disclosure. We request that SEBI clarify this point.

5. Securities Lending

India is one of the few countries that does not allow some form of securities lending by institutional investors.[7] The income or interest realized from securities lending can either be added to a portfolio's return or, in some cases, used to offset custody expenses. In either case, it increases the yield of the portfolio and therefore benefits shareholders.

Clearly, securities lending arrangements involve an added measure of risk, and mutual funds and other FIIs that engage in securities lending should be required to take measures to

[7] Only five of the fifty-two countries covered in the Institute's Foreign Investing Guide (our guide to basic investment regulations) prohibit securities lending. Securities lending is not commonly practiced in nine other countries covered by this Guide.

mitigate this risk. These could include appropriate limits on the total amount of portfolio securities that could be loaned at any one time, requirements for collateralization (along with requirements to mark-to-market that collateral), mandatory termination provisions that allow the fund to terminate the loan at any time, and limitations on the fees and expenses involved in the arrangement.[8] We encourage SEBI to consider allowing securities lending under appropriate circumstances.

6. Participation in India's Futures Market

We understand that India has recently launched a single-stock futures market, and currently allows domestic institutional investors, but not FIIs, to purchase and sell futures contracts on that market. We would strongly urge SEBI to allow FIIs to participate in that market on equal terms with domestic institutional investors.

C. Tax Issues

1. Capital Gains Taxes

While many countries (including India and the U.S., among others) impose capital gains tax on domestic investors, India is relatively unique in also imposing capital gains tax on foreign investors. In most countries, foreign investors are exempt from capital gains tax either by statute (such as in the U.S.) or by income tax treaty. Most of India's tax treaties (with the notable exception of the India-Mauritius treaty) do not provide a capital gains tax exemption for foreign investors.

The Indian capital gains tax creates a serious disincentive to investment in Indian securities. Much of the foreign investment in India today is made indirectly, through companies formed in Mauritius, to take advantage of the capital gains tax exemption in the India-Mauritius tax treaty. However, not all FIIs can utilize a Mauritius structure. For example, regulatory issues under the Investment Company Act limit the ability of U.S. mutual funds to invest in India through Mauritius. Even for the FIIs that can utilize such a structure, the costs attendant to creating it serve as a disincentive to investment in Indian securities.

We believe that India should remove these disincentives by enacting a statutory exemption from capital gains tax for all FIIs. This would remove this disincentive for U.S. mutual funds and other FIIs that are unable to take advantage of a Mauritius structure to invest in Indian securities by eliminating the capital gains tax, and would reduce the costs of investing for those FIIs that can use a Mauritius structure. If a statutory exemption cannot be enacted expeditiously, consideration should be given to an administrative exemption for these foreign investors. If neither a statutory or regulatory solution are feasible, India should seek to modify its tax treaties (including most specifically the U.S.-India treaty) to provide this exemption.

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[8] Mutual funds are significant participants in the securities lending business in the U.S. For a discussion of the types of conditions that the staff of the U.S. SEC has placed on securities lending by mutual funds, *see* Lemke, Lins & Smith, REGULATION OF INVESTMENT COMPANIES, § 8.02[1][d][vi].

We also strongly recommend that, as an interim measure (until foreign investors are exempt from Indian capital gains tax), the Indian tax authorities provide the requested relief for the following issues.

a. Netting

India provides favorable rules for FIIs with both capital gains and capital losses by permitting these gains and losses to be offset at the FII level; this netting occurs by offsetting the aggregate amount of capital gains in all of an FII's subaccounts against the aggregate amount of capital losses in all of its subaccounts. Consequently, a FII with only gains in one subaccount and only losses in another subaccount can offset these gains and losses at the FII level, even though no offset would occur in this example if netting were permitted only at the subaccount level.

Notwithstanding the generally-favorable treatment that arises from this approach, FII-level netting would cause U.S. mutual funds organized as series funds (where each series is a subaccount of the series fund's FII license) to violate the Investment Company Act. U.S. law treats each series as a separate investment company and each is taxed separately on its earnings. The Investment Company Act's prohibitions on affiliated fund transactions would be violated if gains of one series could be used to be offset the losses of another series – since the netting effectively would transfers the benefit of one fund's tax loss to an affiliated fund.

Consequently, we strongly urge Indian law to permit FIIs to elect to net gains and losses only at the subaccount level. As an FII taking advantage of this election would pay more capital gains tax to the Indian government than an FII applying the general FII-level netting rule, this election would only be used by FIIs, such as U.S. mutual funds organized as series funds, that cannot use the general FII-level netting rule without violating their domestic laws.

b. Cost Block Selection Methods

We recommend that India adopt more flexible rules for determining the cost basis of shares sold. As we understand Indian law, capital gain and loss must be determined by treating the shares held the longest as those sold first – the "first-in/first-out" (FIFO) lot selection method. Other lot selection methods, such as the specific identification method permitted in the U.S., provide taxpayers with more flexibility to determine the gain or loss on shares sold and can be an important element in encouraging investment in a country that still imposes capital gains tax on foreign investors. We therefore recommend that India allow FIIs to elect to use the specific identification method to calculate capital gains and losses.

c. Clarification on Offsetting Capital Gains and Losses

Indian legislation that became effective beginning April 1, 2002 prohibits FIIs from using net long-term losses (the excess of net long-term losses over net long-term gains) to offset net short-term gains (the excess of net short-term gains over net short-term losses). This rule disadvantages FIIs by imposing tax on net short-term gains and requiring that net long-term losses be carried forward to the next year in which the FII has net long-term gains. This carryforward treatment also is unique, in that FIIs are required to net short-term losses against

long-term gains. FIIs would receive neutral netting treatment if the 2002 law were amended to permit the netting of long-term losses against short-term gains.

A second equally important netting issue relates to the lack of guidance regarding the netting rules that applied to gains and losses realized before April 1, 2002. Specifically, many FIIs have disputes before the Indian tax authorities because they developed netting procedures (in the absence of guidance) that are now being challenged. These disputes could be expeditiously resolved if the Indian tax authorities would clarify the any netting conventions adopted by taxpayers prior to April 1, 2002 will be respected for that period.

2. Withholding Taxes on Dividends

In India, each issuer withholds taxes on dividends at source, typically at the statutory withholding rate of 20%. (There is an additional 5% surcharge, making the effective rate 21%.) The withholding tax rate in India's tax treaties is typically lower. FIIs are able to reclaim any amounts withheld in excess of their applicable treaty rate, but the reclaim process generally takes at least two to three years.

In order to improve this process and further encourage foreign investment in India, we strongly recommend that Indian custodians be permitted to withhold taxes owed by their FII clients at the applicable treaty rates. This at-source withholding regime (which also is used by the U.S.) would ensure that foreign investors pay the appropriate amount of tax without the administrative burdens and delays that arise under the present regime. If an at-source withholding regime cannot be implemented, then at a minimum the current system should be streamlined so that reclaims are processed expeditiously and with minimal burden on FIIs.

CONCLUSION

As we mentioned at the beginning of this letter, SEBI has made great strides in improving the environment for foreign investors in India over the past few years. However, as indicated by the lengthy list of recommendations in this letter, there is more that could be done. We appreciate SEBI's request for our views on possible improvements.

We believe that many of our recommendations can be implemented relatively quickly and easily, and would significantly improve the FII regime and therefore make India a more attractive place for foreign investors. These include further streamlining the initial application process for FIIs by reducing the amount of supporting documentation required and reducing or eliminating the $5,000 fee, eliminating the need to renew licenses every five years, and improving the approval process for adding subaccounts. Adding an exception from the "broad-based" 10% rule for FIIs that meet certain other objective standards (such as investment objectives consistent with making investments in India) also would greatly improve the application process for new funds. In addition, adopting a rule that bars claims of prior ownership to dematerialized shares and an across-the-board 10% trading collar for all listed securities would remove two major disincentives to investment in Indian securities.

We recognize that some of our other recommendations may take longer to implement. However, we believe that seeking improvements in the taxation of FII investments, the system

through which FIIs invest in IPOs, and the system for reporting significant portfolio holdings are all very important to the long-range attractiveness of Indian investments. We hope that SEBI will seriously consider each of these recommendations.

Finally, although all of these recommendations would improve the environment for FIIs, we continue to believe that the FII regime itself should be abolished, and we would strongly urge SEBI to work towards this ultimate goal.

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We appreciate the opportunity to provide our views on the issues FIIs face as investors in the Indian securities markets. These are important issues, and we applaud SEBI for seeking input from the private sector.

We would welcome the opportunity to discuss these comments and recommendations with you. Please feel free to contact me at 202-326-5826 (phone), 202-326-5841 (fax) or *podesta@ici.org* (e-mail), or Bob Grohowski at 202-371-5430 (phone), 202-326-5841 (fax) or *rcg@ici.org* (e-mail).

Sincerely,

Mary S. Podesta

Mary S. Podesta
Senior Counsel